



April 1998

Privatization

Questions State and Local Decisionmakers Used When Considering Privatization Options

Preface

Over the past several years, state and local governments have increased their use of various types of privatization. Privatization is commonly defined as any process that is aimed at shifting functions and responsibilities, in whole or in part, from the government to the private sector through such activities as contracting out or asset sales.¹ A 1997 Council of State Governments' survey found that state agencies responsible for transportation, corrections, higher education, and social services had all increased privatization activities since 1988.² According to the International City/County Management Association, city governments have also increased the number and types of services contracted, such as child welfare programs, health services, street maintenance, and data processing.³

Congress and the administration indicated an interest in having the federal government increase its use of privatization. In light of this interest, we were asked by the Chairman of the

¹See Terms Related to Privatization Activities and Processes (GAO/GGD-97-121, July 1997).

²Private Practices: A Review of Privatization in State Government, Council of State Governments (Lexington, KY: Nov. 1997).

³International City/County Management Association Municipal Year Book 1994: Alternative Service Delivery in Local Government, 1982-1992 (Washington, D.C.: 1994), p. 28.

House Task Force on Privatization to identify lessons learned by state and city governments in implementing privatization efforts. Our subsequent report, Privatization: Lessons Learned by State and Local Governments (GAO/ GGD-97-48, Mar. 14, 1997), discussed privatization lessons learned by, and the related experiences of, the states of Georgia, Massachusetts, Michigan, New York, and Virginia as well as the city of Indianapolis, Indiana.

This publication responds to a request from the task force Chairman and several other Members of the House of Representatives that we identify the critical questions that state and local decisionmakers found useful when considering whether to privatize a government activity. The questions in this publication were identified by decisionmakers in the state and local governments we discussed in our March 1997 report and correspond to the lessons learned by those governments. In preparing this publication, in March 1998, we provided privatization officials from the six governments a draft of the questions for their review and comment. All six governments concurred with the questions and provided comments, which we have included as appropriate.

Major contributors to this publication were John K. Needham, Donald L. Bumgardner, Kiki Theodoropoulos, and Marlene Zacharias. If there are any questions on the material in this publication, please contact me on (202) 512-8676.

A handwritten signature in black ink, appearing to read "J. Christopher Mihm". The signature is fluid and cursive, with the first name "J." and last name "Mihm" being more distinct than the middle name "Christopher".

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Introduction

The six governments we visited tailored their approaches to privatization to their particular political, economic, and labor environments. We selected the states of Georgia, Massachusetts, Michigan, New York, and Virginia because, at the time, they had the most extensive privatization efforts involving activities that correlate with those performed at the federal level. We selected the city of Indianapolis because it was cited more frequently by the panel of privatization experts we consulted than any other city or state for its privatization experience. On the basis of our review of the relevant literature, the views of a panel of privatization experts, and our work at the state and local governments, we identified—as shown in the figure—six lessons that were generally common to all of the governments in implementing privatization initiatives.

Figure: Lessons Common to State and Local Governments



Political Champion

Political Champion

Privatization can be best introduced and sustained when there is a committed political leader to champion it. In the six governments, a political leader or, in one case, several leaders working in concert played a crucial role in introducing privatization. These leaders built internal and external support for privatization, sustained momentum for their privatization initiatives, and adjusted implementation strategies when barriers to privatization arose.

The chief executive (i.e., the governor or mayor) was the political champion for the most recent privatization efforts in Georgia, Massachusetts, Michigan, New York, and Indianapolis. In Virginia, key state legislators and the governor worked together to introduce new privatization initiatives.

Questions Concerning Political Champion Issues

1. Who in the government will provide leadership in assessing the case for privatization and supporting the privatization effort once it is under way?
2. Is the activity viewed by policymakers and other stakeholders as one the government should (1) provide and produce, (2) provide but not produce, or (3) not produce, and have other options to improve the activity been considered?
3. Should the government involve the private sector in the activity or is the activity so intimately related to the public interest that it is inherently governmental?
4. Will private sector participation improve performance of the activity? That is:
 - Are there substantial problems in current service delivery?
 - Are there benchmarks that indicate potential for cost savings or service quality improvements?
 - Will privatization increase choices available to citizens?
5. Do policymakers, agency officials, and other stakeholders agree on the goals the privatization is to achieve?
6. Will the users of the service, interest groups, or public officials be resistant to changes in service providers? If so, how will this resistance be mitigated?
7. Is there a need for an advisory group or commission to identify activities that are candidates for privatization and to build consensus for it?

Implementation Structure

Implementation Structure

Once political leaders introduce privatization, governments need to establish an organizational and analytical structure to implement the privatization effort. This structure can include commissions, staff offices, and analytical frameworks for privatization decisionmaking. Five of the six governments we reviewed established governmentwide commissions to identify privatization opportunities among government activities and to set policies to guide privatization initiatives. The commissions were created either by the chief executive (in Georgia, Michigan, New York, and Indianapolis) or by the state legislature (in Virginia). Massachusetts did not use a commission; instead, cabinet secretaries selected the government activities to privatize. The governments found that privatization can take various forms, such as contracting out and asset sales, and that implementation strategies and analyses need to be tailored to the project or situation and will likely vary depending on the form of privatization.

Questions Concerning Implementation Structure

1. Given the nature of the activity, what type of privatization would be most viable and best serve the public interest (e.g., contracting out, managed competition, divestiture)?
2. Is the activity already performed in the private sector?
3. Is there a competitive marketplace? If not, can one be created?
4. Are there barriers to entry by private firms, such as significant start-up costs? If so, can they be mitigated?
5. Are there factors that could limit the use of privatization, such as “natural monopolies,” in which production cannot be duplicated (e.g., a single source for city water supply); and “public goods” that cannot sustain private markets? If so, how could these factors be mitigated?
6. Will the contractual arrangements and the type of service permit the government to switch from one service provider to another without serious disruption in the flow of service or undue cost at the end of the contract or option year?
7. Will there be an office and/or knowledgeable staff available to collect and analyze performance and cost data and provide technical assistance to agencies?
8. Have the legal, financial, and technical risks/liabilities to the government been identified, considered, and evaluated?
9. What will be done with the activity’s current facilities, technology, and other resources?

Legislative and Resource Changes

Legislative and Resource Changes

Governments may need to enact legislative changes and/or reduce resources available to government agencies in order to encourage greater use of privatization. Georgia, for example, enacted legislation to reform the state's civil service and to reduce the operating funds of state agencies. Virginia reduced the size of the state's workforce and enacted legislation to establish an independent state council to foster privatization efforts. These actions, officials told us, sent a signal to managers and employees that political leaders were serious about implementing privatization.

Questions Concerning Legislative and Resource Changes

1. Are there statutory or regulatory barriers to private sector performance of the activity? That is:

- Are there laws, tax policies, regulations, or grant requirements that either mandate or constrain who can perform the activity?
- What are the implications of these legal and regulatory requirements for a potential privatization?

2. Will there need to be a change in the statutory or regulatory requirements to ensure a successful privatization for a particular activity? That is:

- Is there support for such a change?
- Are the changes to laws or regulations feasible in the current political and economic environment?

3. Are there relationships with other state or federal programs prescribed by law that could inhibit or prohibit a change in service providers (e.g., interservice support agreements, intergovernmental agreements)?

4. What incentives are most appropriate for improving performance and maximizing savings through privatization (e.g., using savings to improve other agency activities)?

5. If there are savings from the privatization, either initially or over the long term, how will they be distributed (e.g., reinvested through service improvements, tax reductions, or deficit reduction)?

6. Under what conditions will the private sector provide needed equipment or facilities that are not owned by the government?

Reliable Cost Data

Reliable Cost Data

Reliable and complete cost data on government activities are needed to assess the overall performance of activities targeted for privatization, to support informed privatization decisions, and to make these decisions easier to implement and justify to potential critics. Most of the governments we surveyed used estimated cost data, because obtaining complete cost⁴ and performance data by activity from their accounting systems was difficult. However, Indianapolis and more recently Virginia used new techniques, such as activity-based costing to obtain more precise and complete cost data. Although the use of estimated cost data can save a government the time and cost associated with preparing more accurate data, the resulting imprecision can have negative consequences. For example, in Massachusetts, the State Auditor questioned savings reported from privatized activities because an inadequate cost analysis was done before the privatization.

⁴Complete costs are generally defined as the fully allocated costs of an activity. These include all direct and indirect personnel costs, materials and supplies, equipment, capital depreciation cost, rent, maintenance and repairs, utilities, insurance, personnel travel, operations overhead, and general and administrative overhead.

Questions Concerning Reliable Cost Data

1. Has evidence been presented on the potential for significant enhancements to economy, efficiency, or effectiveness? That is:

- Has a cost/benefit analysis of a possible privatization been done, including the effects of shifting costs to service recipients?
- Have tangible benefits—such as operating and capital cost savings, higher quality services, more or better service delivery options—been identified?
- Would providing potential contractors with a draft “request for proposals” yield useful information on what cost and service quality improvements might be possible with privatization?

2. Have the complete costs of alternative service providers been considered (i.e., costs of retaining the activity in-house; cost implications of a long-term commitment; start-up and capital investment costs; conversion costs, including the sale of surplus property and transactional costs involved in displacing government employees; and government costs to monitor private sector performance)?

3. Does the relevant government office have the accounting systems to produce complete cost data in order to make a valid comparison to the private sector’s cost? If not, are cost estimates acceptable for making such a comparison, and/or would the use of activity-based costing methods be feasible on a case-by-case basis?

4. If the private sector is unable to meet its contractual obligations, have potential alternatives and the estimated costs of resuming responsibility for the operation been considered?

Strategies for Workforce Transition

Strategies for Workforce Transition

We found that governments needed to develop strategies to help their workforces make the transition to a private sector environment. Such strategies, for example, might seek to involve employees in the privatization process, provide training to help prepare them for privatization, and create a safety net for displaced employees. For example, all six governments developed programs or policies to address employee concerns with possible job loss due to privatization. These strategies included offering workers early retirement, severance pay, or a buyout or, if the activity was taken over by a private firm, ensuring that employees' concerns about compensation issues were addressed.

Because Virginia found that employees' concerns were one of the biggest barriers to privatization, the governor directed state officials to identify ways for departing state workers to compete in the private sector. This led to the passage of the Workforce Transition Act, which mitigated some of the employees' concerns, such as job loss, training, and benefits.

Questions Concerning Workforce Transition

1. What role will the government agency initially have in considering privatization as a strategy? Will the agency be allowed to compete with private sector firms and submit a proposal to perform the service? If so, under what terms and conditions? How will the competition process be coordinated with the regular procurement process? Who will oversee the competition process?
2. If the activity is privatized, what will be the impact on the employment status and the portability of their pensions and benefits? Will training be provided to government employees?
3. What will be the impact on union employees? How will the government comply with contractual and civil service requirements?
4. Do requirements of current labor contracts pose a challenge to privatization? If so, what are the implications of these requirements for the privatization, and can these contracts be revised?
5. Will public policies, such as equal employment opportunities, be changed if the service provider is changed and government employees transfer to the private sector?

Monitoring and Oversight

Monitoring and Oversight

When a government's role in the delivery of services is reduced but not eliminated through privatization, monitoring and oversight is needed that evaluates compliance with the terms of the privatization agreement and evaluates performance in delivering services.

Officials from all six governments worked to enhance their employees' skills so that they could undertake more sophisticated especially for complex activities, such as wastewater treatment or the medical care of prisoners. Monitoring performance sometimes required new or innovative approaches. For example, Virginia used a newly designed approach to measure the performance of its two contractor-operated child support enforcement offices. Virginia established quarterly and semiannual reporting requirements in the contract, using statistical measures to compare the performance of contractor-operated child support offices with a hypothetical office with similarities in such areas as size and demographics.

Questions Concerning Monitoring and Oversight

1. Can the government maintain necessary control and accountability for activities that have been contracted out?

That is:

- Does the government have and will it maintain the capacity (e.g., the expertise, staff, funding) to provide suitable oversight of private sector performance?
- If not, can the agency recruit, attract, retain, and train employees with the necessary knowledge and skills?
- Does the government retain the legal authority to provide effective oversight?

2. If the activity has been divested, does the government retain regulatory responsibilities after the divestiture?

3. Have the criteria (e.g., cost, quality, customer service, timeliness) that will be used to evaluate the privatized activity been defined?

4. What incentives and penalties will be used in contractual arrangements to ensure desired performance?

5. Are performance and cost requirements specified and measurement systems in place?

6. Does the government agency have an effective quality control system in place, or can it be developed to determine conformance to contractual requirements?

7. Do potential contractors have a record for effective performance and quality control on prior projects?

8. Will there be sufficient funding to pay for oversight and quality control?

Notes

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